



January 4, 1967

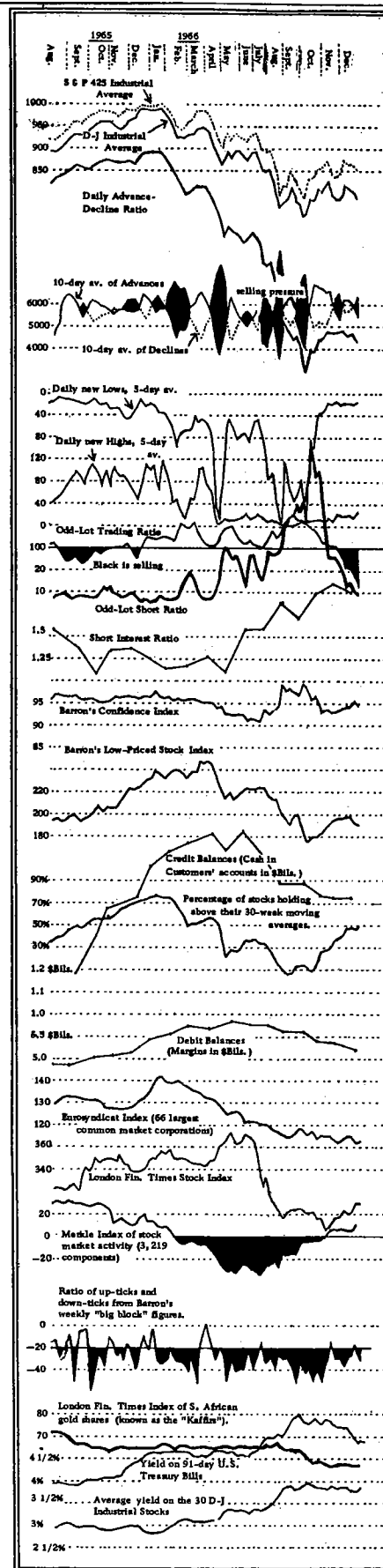
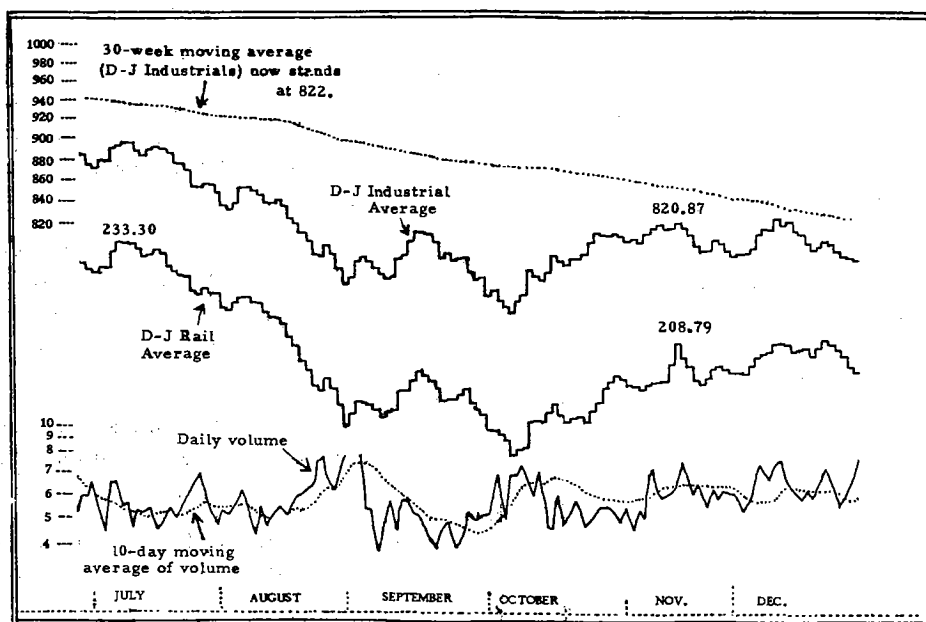
Letter 345

THE MARKET: In the last Letter I explained why, from a Dow Theory standpoint, the action of the market during November and December was unsatisfactory—if not downright ominous. According to Dow Theory a movement terminates at the point where the Industrials and Rails establish their last confirmed highs (or lows). The two Averages recorded their last confirmed highs on November 16, Industrials at 820.87, Rails at 208.79. Following a late-November decline, the Averages again rallied. On the (December) rally Rails bettered their November peak by 3¢, but Industrials failed to confirm. I consider that December produced a dangerous non-confirmation, all the more dangerous since it occurred at the top of a rally within a confirmed primary bear market. I believe that the Averages were saying "watch out" during December, even though most Wall Street analysts appeared to have been mesmerized by the "bullishness" of a single indicator, the short position on the N.Y.S.E.

For new subscribers I want to take this paragraph to state that we have been (since last February) in a primary bear market. Our policy has been to be out of all equities and in 91-day U.S. Treasury bills. As a hedge against possible devaluation, I have also advocated a 10% to 15% position in assorted gold shares. For 11 months my efforts have been directed towards keeping my subscribers solvent, liquid, out of the market and psychologically ready to withstand the periodic spates of bullishness which have cost so many people so much over the past year. That policy continues unchanged, and it will remain unchanged until I consider the bear market to be over. At that time, I believe we may arrive at a once-in-a-generation bargain area for investors who are ready to buy blue-chip and growth stocks at greatly depressed prices.

The performance of the market at the end of 1966 was an extraordinary one by any reckoning. When the market does not do what "it is supposed to do," it pays to recheck one's thinking. The action during December should have given any bull food for thought.

There is a very strong seasonal pattern during the month of December. Historically, December is an "up" month, and only 3 times in the last 20 years (1953, 1957, 1964) did the Industrial Average close lower at the end of December than at the end of November. The Industrials closed out the month of November, 1966 at 791.59. At the



Page 2 close of December, 1966, the Industrial Average stood at 785.69. The fact that the late-December low was below the late-November low constitutes a definite element of weakness in the current market.

Historically, the trend of the market during the post-Christmas week is even more consistent. On only 2 occasions in the last 20 years (1948 and 1953) did the Industrial Average produce a net decline during the final week. During those 2 exceptions the net losses for the week were exceedingly small (12¢ in 1948, 2¢ in 1953). The 13 point loss for the final week of 1966 is the greatest such loss for that week seen in this generation.

What of the action during January as an omen of things to come? There is a good deal of significance in the January market performance. Based on past history, if the December low is violated in January, the odds are heavily in favor of a poor first half during the new year. In the present instance, the market has already shown weakness by breaking the November low in December. It has shown further weakness by declining during the final post-Christmas week. If the decline continues during January, then the odds would favor a poor first half for the market. While there is, of course, no certainty in observations based on past case histories, I would have to say that the outlook for the market for 1967 is poor, based on one of the worst November-December performances on record.

"Maven" is a good Jewish word meaning "an expert," and one often hears this word used in New York City (a city which has a high regard for mavens of all varieties). In reading dozens of financial publications, I note that suddenly all the market mavens are talking about a "5% or possibly a 10% drop in corporate earnings next year." In my opinion, these men are simply "wishing it up." The record of every secondary market reaction and subsequent business recession since World War II indicates a bigger drop in corporate profits than 10%. In the 1948-49 recession profits dropped 24% from their preceding high. In 1950-52 profits dropped 28% from the preceding peak. In 1954 profits slid 18% from the 1953 high. In 1958 corporate profits dropped 28% from the preceding peak.

Now, for the first time since World War II the market and the economy are in the grip of a primary bear market. Despite this, Wall Street experts are talking about a 5% to 10% drop in corporate profits. My only advice is this—be skeptical. The odds are heavily in favor of a drop of 20% or more in corporate profits next year. And if the primary bear market is to be more vicious than the secondary reactions since World War II, I would expect more damage to profits than anything seen by this generation. For this reason, a drop next year of 20% or more in corporate profits would not surprise me. In fact, I rather expect it.

THE GATHERING STORM: The Federal Reserve Gold Ratio has dropped to 31.4%. Anything below 30% may be considered critical, since that would put the ratio within "emergency distance" of the 25% statutory (legal) limit. Reflecting the gathering storm, the price of gold on December 22 rose in London to a 1966 peak of \$35.194.

Ironically, I believe that the public is now completely apathetic regarding the gold picture. It is a case of "Wolf" having been cried too many times before. At this point no one is ready to believe anything can happen to gold. It hasn't happened in 33 years, why should it start now?

Nevertheless, a number of critical situations are developing, each or all of which could affect the entire gold picture. (1) Britain remains in poor financial shape. The third quarter, 1966, deficit in the British balance-of-payments increased to an annual rate of \$1.7 billion

NOTES & QUOTES: By all accounts, money rates "saw their highs" in August-September, 1966. By all accounts but mine and a very few others, that is. In Letter 342 I wrote that I expected the Treasury to come into the bond market in a massive way during 1967. The Treasury will come in to "gather money" to cover Vietnam and other expenses; the 1967 budget deficit should be substantial if not absolutely whopping.

Writing of the bond rally, economist Eliot Janeway states in his Janeway Letter (Dec. 20): "The end of this (bond) rally is very easy to spot—it has a rendezvous with January's budgetary news and with the resumption of the Government's asset disposal program, which together will knock it on the head. The rally in the stock market has been following the rally in the bond market. Its disillusionment is, too.

"We urge subscribers to take literally the warning from Senate Finance Committee Chairman Russell Long that the Federal budget deficit for the next fiscal year could reach \$20 billion. We warn again that no tax increase move is at all likely to relieve budgetary pressures upon the money market."

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And here from Alden Well's December Monetary Report: "In 1967 we expect continued high interest rates, and one or two occasions when bond prices will sink below the August-September level. Money, particularly in the large metropolitan centers, will continue tight. Economic barriers between nations will increase, and the cost of Government go up. Unemployment under these conditions, should rise all over the world, as it has already in Britain and West Germany. Traders in debt securities, we believe, would at this time be well advised to move from long-term to short-term. By the time the latter mature, long-term bonds may be again low, perhaps a new low. At this time they can reverse their position. Those interested solely in long-term safe income might be interested that we expect a long period of high interest rates with yields on quality bonds at times going as high as 7%."

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Meanwhile, on the political front our leaders are bungling things in an almost spectacular way. As predicted here many months ago, Europe (which is beginning to question the whole U.S.—European alliance) is moving away from the U.S. and moving towards de Gaulle.

Early in December Secretary Rusk reminded our allies that NATO is as much committed to defend the U.S. as the U.S. is committed to defend them. When one realizes the extent of current U.S. commitments, it is no wonder that Europe is aghast. Writing of this, Walter Lippmann commented last week: "Secretary Rusk could have done nothing to make the Europeans realize more vividly the point of Gen. Charles de Gaulle's case against NATO. For what the general has been telling the Europeans is that if they do not break with the integrated command structure and renounce the automatic character of the commitment they run a grave risk of being drawn into nuclear war by the United States in its quarrel with China.

"Nothing Rusk could have done could have been a greater clincher on the determination of the Europeans, including our British allies, to stay clear of the Vietnamese war and the whole American policy in Asia.

"Rusk's trip to Paris has done more than anything else in recent times to make certain that what is called Gaullism will, in fact, become postwar Europeanism."

A final comment about the situation from James Reston of the New York Times (Dec. 23): "The muttering against Secretary Rusk within his own department and the Cabinet is the talk of the capital. He has not produced the leadership or the organization the department needs, and the job is too important for a tired man."

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from a second quarter (deficit) rate of \$1 billion. The pound is the "sister" reserve currency to the dollar. Any persistent weakness in the pound is sure to be reflected in pressure on the dollar. The pound could remain in trouble due to the adverse balance-of-payments in Britain or from a number of other sources.

(2) Britain, through the U.N., has imposed sanctions on Rhodesia. Even though sanctions have proved useless in the past, the real danger here is the possibility that South Africa will feel forced to defend Rhodesia (and indirectly herself). One (monetary) battle line has already been drawn. South Africa (see clip) has now cut her gold shipments to London in half. This loss of gold could pose a staggering problem for the London Gold Pool (the U.S. owns one half of the Pool). The Gold Pool was formed for the purpose of stabilizing the price of gold. But with S. African shipments to London halved, it is probable that the U.S. will be called on to supply gold to the Pool (the Pool sells gold on the open market whenever the price of gold is in danger of running away on the upside). The reason the U.S. will have to supply the gold is clear enough: Britain, to all intents and purposes, is broke. Britain simply is not able to supply any large amounts of gold to the London Gold Pool.

(3) The Group of Ten (a sub-group of the International Monetary Fund) is slated to meet at the end of January. For the first time, the meeting has been called specifically to discuss the gold problem. France, loaded with gold and distrustful of U.S. and British intentions, has literally forced the meeting. Germany, which has been drawing away from the U.S. and nearer to France, is also in a strong gold position and presumably would be interested in revaluation.

Europe is moving towards an economic slump and a liquidity crisis. The liquidity crisis has been brought on by heavy U.S. spending (government, corporate and individual), and a resulting "call back" of dollars by leading U.S. corporations. Without dollars, which are the leading reserve currency of the Free World, the European boom is doomed. It is believed that France will present a list of monetary recommendations at the I.M.F. meeting. One recommendation will be a call for a doubling of the price of gold. Another will be that the U.S. and Britain use half of their gold reserves (which would then have doubled in value) to pay off their international debts. Veteran readers of these Letters will immediately recognize both of these concepts as coming from the mind of de Gaulle's master fiscal planner and the leading monetary conservative of the Western World, Jacques Rueff.

(4) One of the few possible ways in which Britain could become competitive again would be to join the Common Market, and to receive the benefits thereof. But here again, Britain must reckon with France. It is believed that one of the requirements which de Gaulle will insist upon before Britain is admitted to the Common Market is a devaluation of the pound. Such a devaluation could upset the monetary balance of the entire world, and it could put immediate pressure on the dollar. It is probable that de Gaulle would prefer a world revaluation of gold, based on an I.M.F. agreement rather than a unilateral devaluation by Britain preparatory to that nation's entrance into the Common Market.

(5) Finally, adding fuel to the fire is the rapidly developing silver situation. Here again we have a case of "Wolf" having been cried too many times. No one really believes that the price of silver is about to "take off." Even fewer realize that historically, there has been a fairly consistent ratio between the price of silver and the price of gold. In other words, a surge in the price of one is likely to put upward pressure on the price of the other.

Here are the silver facts. Of 600 million remaining ounces of silver (at the U.S. Treasury), 440 million ounces are earmarked for backing of silver certificates. Of the remaining 160 million ounces, all are reserved for the U.S. strategic stockpile. This means that industry is now buying around 4 million ounces of silver per week from the Treasury, silver which is in effect already accounted for. The "silver emergency" is now on, and the Treasury must decide whether to repudiate silver certificates (an act which would have dangerous psychological overtones) or simply stop the sale of silver (which really would accomplish nothing).

As I review the whole situation, I am reminded of my own personal adage regarding Government in action. It is this: "Government and the politicians never move in a distasteful situation unless their backs are against the wall. Then the action is of an emergency nature and most likely to be wrong." Those of us who are hedged in 10% to 15% gold and silver shares should continue to do what I have been recommending all along.....sit and await developments.

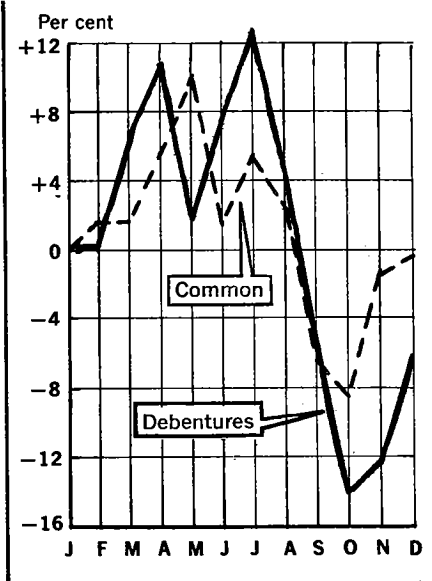
CONVERTIBLES: During 1965 and early 1966 much was heard about convertible debentures, the "foolproof way of having your cake and eating it too." The idea (which has worked well for many years) was that a convertible bond is both a bond and a hedge on the upward action of the stock into which it is convertible. If the stock rallies, the convertible bond will rise, since there is a definite ratio between the bond and the stock into which it can be converted. On the other hand, if the stock drops below conversion price, the bond will tend to hold on the downside because the fixed interest feature of the bond provides a yield floor. In other words, on the downside the convertible bond becomes a real bond and it is held up by its fixed yield feature.

So. African Gold Leaving London Metal Market

(Chicago Tribune Press Service)
JOHANNESBURG, South Africa, Dec. 10.—What's happening to South Africa's gold? Traditionally South Africa, producer of two-thirds of the free world's gold, sells it all on the London metal market. But during the first nine months of this year about 50 per cent less gold has been shipped from here to London, despite the fact that production of South Africa's gold mines has increased and exceeds a billion dollars a year.

Page 4 The only real danger in convertibles has been the possibility of paying too high a premium for the bond over the conversion price. For example, if a bond is convertible into 10 shares of its stock at 100, the bond is worth 1000 as a convertible as long as the common holds at 100. If the coupon on the bond is 5%, then the bond is worth 1000 as long as interest rates are holding at around the 5% rate for most bonds. But often a convertible sells at a premium because the stock which it is convertible into is a "hot issue" or a growth issue. For instance, the bond which is worth 1000 as a bond (at 5% interest) and also 1000 (since it can be converted into 10 shares of stock at 100 per share) might sell for 1150. The "premium" is then 150 or 150 over conversion price. The danger here is that if the stock collapses, the premium (150) may disappear, even though the 5% fixed interest rate will tend to hold the convertible up because it is also a bond regardless of the price of stock it is convertible into.

All very well in normal markets. But 1966 proved that a bear market can be a disaster for everybody. The accompanying chart shows an average of a representative group of common stocks and an average of their (convertible) debentures or bonds. What happened here is that as the common stocks caved in, the bonds also declined sharply. But it came as a shock to see interest rates rise in 1966 as stocks declined. Thus the "floor" (based on prevailing interest rates) under the bonds also declined and a 5% bond which was worth say 1000 in early 1966 was worth only 930 in late 1966 as the bond market fell in line with rising interest rates. Most shocking of all was the fact that the premiums on many convertibles disappeared, and this left the convertible average at a lower level than the common stock average of the same companies. Thus, the great convertible hedge did not work in 1966. In fact, investors with representative listings of convertibles lost more, on average, than the holders of the common stocks in the same companies.



Currently, interest rates are easing, and this is stirring up renewed enthusiasm for convertibles. But my advice is to leave convertible bonds alone, particularly those which sell at a high premium over conversion. The reason: I don't trust the bond or the stock market. If interest rates push up again in 1967 (see Notes & Quotes section) the same misfortune which befell 1966's convertible holders could occur again in 1967. In a bear market, the only real safety is cash or its equivalent (i. e. 91-day Treasury bills).

STOCKS: In Letter 316 I drew attention to "the rule of the giants." Simply stated, the rule is this: declining trends and new lows in both duPont and General Motors have (in the past) provided reliable indications of forthcoming trouble in the market. Evidently, when the equities of these two giants, whose purchasing and selling power affects (directly and indirectly) almost everyone in the nation, are in a declining trend, the implications are so powerful that the entire market can be expected to follow.

General Motors broke to new lows during early December, and duPont recorded new lows in late December. The new lows established by both of these bellwether stocks must be taken as a negative influence on the market. As seen on the daily charts, both DD and GM are now at or near their lows for the year. The relative strength lines on both issues are confirming by breaking into new low territory. Note in both cases how the declining trend in relative strength led the actual price of these two stocks. (Charts courtesy of Traders Research, 1431 Pearl St., Alton, Ill. 62003). (Late Note... On the final trading session of 1966 both GM and DD broke to new 1966 lows. This performance hardly bodes well for the market).

